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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 900

JOHN E. SHERIDAN AND LEO A. CROSSEN, TRUSTEES, MIFFLIN CHEMICAL CORPORATION, DEBTOR IN BANKRUPTCY REORGANIZATION PROCEEDINGS, SECTION 77B,
Petitioners,

vs.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

HARRY SHAPIRO,
Counsel for Petitioners.

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Petitioners,

vs.

WALTER J. ROTHENSIES, COLLECTOR OF INTERNAL REVENUE, FIRST COLLECTION DISTRICT OF PENNSYLVANIA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable the Justices of the Supreme Court of the United States:

The petition of John E. Sheridan and Leo A. Crossen, Trustees for Mifflin Chemical Corporation, debtor, petitioners, by their attorneys, Harry Shapiro, Esq., and Wexler and Weisman, Esqs., respectfully prays that a writ of certiorari issue to review the decree of the Circuit Court of Appeals for the Third Circuit entered on October 29, 1941, affirming a certain order entered by the District Court of the United States for the Eastern District of Pennsylvania.

Statement of Case.

On January 14, 1938, Mifflin Chemical Corporation, the debtor above named, filed a petition for reorganization under Section 77B of the then Bankruptcy Act. Judge Kirkpatrick allowed the petition, continued the debtor in possession, and referred the matter generally to David Werner Amram, Esq., as Special Master.

Walter J. Rothensies, Collector of Internal Revenue for the first collection district of Pennsylvania, thereafter filed a jeopardy tax claim against the debtor in the amount of $254,746.80.

The tax was assessed on the theory that the debtor sold rubbing alcohol to certain of its customers in excess of their reasonable requirements in violation of Article 146 of Regulations No. 3 promulgated by the Commissioner of Internal Revenue, as amended by Treasury Decision 4541, approved April 17, 1935 (Volume 33, Treasury Decisions, Internal Revenue, 90, 93) which provides, in part, as follows:

> "The sales of this product must be confined to persons legitimately engaged in a bona fide drug trade * * * Failure to comply with these requirements and to confine sales to such persons, or the making of sales to such persons in quantities in excess of their reasonable requirements, will constitute bad faith on the part of the permittee and grounds for the revocation of his permit."

The Collector further contended that since the sale of rubbing alcohol compound in excess of reasonable requirements violated the quoted regulation, the denatured alcohol so sold became subject to the same tax as undenatured alcohol under the provisions of Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (Act of August 27, 1935, c. 740, §4, 49 Stat. 873, 27 U. S. C. 153), since repealed and incorporated as Section 3111 of the Internal

Revenue Code of 1939 (Act of February 10, 1939, c. 2, §3111, 53 Stat. 1, 26 U. S. C. 3111), which provides as follows:

> "Any person who shall produce, withdraw, sell, transport, or use denatured alcohol, denatured rum, or articles, in violation of laws or regulations now or hereafter in force pertaining thereto, and all such denatured alcohol, denatured rum or articles shall be subject to all provisions of law pertaining to alcohol that is not denatured, including those requiring the payment of tax thereon; and the person so producing, withdrawing, selling, transporting or using the denatured alcohol, denatured rum, or articles shall be required to pay such tax."

The debtor contested the tax claim and the Special Master held a number of hearings to determine the tax claim's validity.

At the hearings the Collector offered testimony in support of the tax claim. The testimony showed that some of the rubbing alcohol compound sold by the debtor to legitimate customers was later resold by the said customers to bootleggers for illegal purposes; that two of the debtor's salesmen knew that some of the alcohol compound so sold by the debtor to its customers was intended to be diverted by the said bootleggers and held conversations with the bootleggers concerning the diversion; that the said salesmen deliberately concealed their knowledge and dealings with the said bootleggers from the debtor because they feared that if the debtor knew of such knowledge and dealings it would discharge the salesmen and cease selling rubbing alcohol compound to customers who resold to the bootleggers.

The record admittedly lacks competent evidence as to the amount of rubbing alcohol sold by the debtor to its customers and resold to bootleggers because the Master,

over the objection of the Collector, refused to hear the testimony of debtor's customers with respect to the disposition made by such customers of the rubbing alcohol purchased from the debtor.

At the conclusion of the claimant's testimony before the Special Master, the debtor moved to dismiss the claim, reserving to itself the right to offer testimony. The claim was thereafter disallowed by the Special Master and consequently the debtor offered no testimony.

The Special Master then prepared and signed a report recommending that the proof of debt of the Collector of Internal Revenue be disallowed. Thereafter the Special Master prepared a supplemental report incorporating certain findings of fact requested by the debtor. Referee Amram died before he signed said supplemental report, and the matter was then referred by the District Court to David Bachman, Esq., as substituted Special Master who approved and filed the said report and supplemental report on July 11, 1939.

The said report and supplemental report of the Special Master summarize the said testimony in narrative form with reference to the page numbers of the testimony (R. 322, 363).

The Special Master found that the debtor and its officers had no knowledge or means of knowledge of the said diversion (R. 358); that all of the customers to whom the debtor sold the rubbing alcohol compound were within the category of persons entitled to purchase the same within Article 146 of Regulations No. 3 (R. 358); that the debtor made no sales of rubbing alcohol compound in bad faith or in excess of the reasonable requirements of its customers (R. 358, 359); that the connection between the debtor's salesmen and the bootleggers was concealed from the debtor and the debtor had no knowledge or means of knowledge thereof (R. 359); that the dealings between the salesmen and the

bootleggers did not occur in pursuance of their duties as salesmen but were for their own benefit to the damage of the debtor, and in violation of orders received by them from the debtor that rubbing alcohol compound was to be sold only for legitimate purposes (R. 359).

Exceptions were thereupon filed by the claimant and a hearing was held thereon before District Judge Bard who, on July 24, 1940, by written opinion filed on said date, set aside the said reports and directed that the said tax claim be allowed in the amount of $187,488.00, together with interest at one-half (½) per cent per month from January 15, 1938. On August 2, 1940, the debtor filed, and on January 14, 1941, Judge Bard dismissed, a motion for rehearing.

On February 10, 1941, Judge Bard entered an order and decree setting aside the Master's reports and allowing the tax claim in the amount of $187,488.00, together with interest at one-half (½) per cent per month from January 15, 1938.

On March 11, 1941, the debtor filed a notice of appeal from the said order and decree.

On April 4, 1941, Judge Bard, upon motion of the Collector and other creditors of the debtor to appoint trustees to supplant Mifflin Chemical Corporation, debtor in possession, appointed John E. Sheridan, Esq., and Leo A. Crossen, Trustees for the debtor corporation. On April 9, 1941, Judge Bard entered an order extending the time for the filing of the record sur appeal for a further period of forty days. Thereafter the Trustees appealed from said order and decree of February 10, 1941, to the Circuit Court of Appeals for the Third Circuit.

At the argument before the Circuit Court, the Trustees urged that Judge Bard erred for the following reasons:

(a) Judge Bard erred in finding that sales in excess of reasonable requirements are prohibited by Article 146 of

Regulations No. 3, and therefore taxable under Section 4 of the said Act, since Article 146 simply deals with the granting of permits for denatured alcohol and the conduct of permittees thereunder and by its terms does not prohibit such sales but simply states that such sales are evidence of bad faith and grounds for the revocation of the permit.

(b) Since the case arose on a demurrer to claimant's testimony sustained by the Master, it was error for Judge Bard to allow the claim without remanding the cause to the Master with instructions to hear the testimony of the Trustees in opposition to the claim, particularly since the Trustees, who represent large and substantial creditor interests, had been appointed after the hearings before the Master had been concluded and his report filed.

(c) The District Court erred in imputing the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin; since, with respect to such wrongful acts and knowledge, the salesmen were engaged, beyond the scope of their authority, and adversely to the interest of Mifflin, in an independent, fraudulent enterprise, whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed.

(d) Since the Master, Judge Bard and the Collector *all* stated that the testimony lacked competent evidence of the *amount* of sales in excess of reasonable requirements, it was error for the District Court to make a finding of the amount of such sales of alcohol and the tax due thereon.

(e) Since the Master's findings of fact are adequately and sufficiently supported by the testimony, Judge Bard erred in setting aside said findings.

(f) The Act and Regulation, if construed so as to impose a tax on sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements, are unconstitutional.

The Circuit Court, on October 29, 1941, affirmed the order of the District Court. It was held that no error was committed in allowing the claim for taxes without remanding the case to the Master to give the Trustees an opportunity to offer testimony for two reasons: *first*, a master functions in an advisory capacity only; he does not sit as a court; and it is his function merely to hear and report his findings of fact and conclusions of law; *secondly*, the Trustees were given an opportunity to be heard, but did not choose to offer testimony, and therefore do not have the right now to obtain another opportunity because of an adverse decision.

The Circuit Court held that "we cannot say that there was no substantial basis" for the factual findings of Judge Bard and, therefore, under FRCP No. 52(a), it could not disturb such factual findings.

The Circuit Court, without discussion, passed over the Trustees' argument that no tax at all can be exacted under the said Regulation and Act with the statement that "Mifflin's contention that alcohol improperly withdrawn is not subject to tax but only subjects the producer or seller to revocation of permit is without foundation."

Finally the Circuit Court concluded that even though Mifflin had no actual knowledge of the illicit distribution of its rubbing alcohol compound, and even though it is conceded that its employees were violating instructions and concealing their activities from Mifflin, Mifflin was nevertheless responsible for the knowledge of its employees under the general rule of *respondeat superior*.

Jurisdiction.

1. The jurisdiction of this Court is invoked under the provisions of Section 240 (a) of the Judicial Code, as amended (March 3, 1891, c. 517, Sec. 6, 26 Stat. 828, as amended; 28 U. S. C. Section 347 (a)).

2. The Circuit Court has decided important questions of federal law which have not been, but should be, settled by this Court; and its decision in other respects is in direct conflict with applicable decisions of this Court and other circuit courts.

3. The date of the opinion and decree of the Circuit Court to be reviewed is October 29, 1941.

Statement of Questions Presented.

1. Are sales of alcohol by a permittee in excess of its customers' reasonable requirements taxable under Article 146 of Treasury Department Regulations No. 3 relative to industrial alcohol, and Section 4 of the Liquor Law Repeal and Enforcement Act of 1935?

2. Are the said Act and Regulation, if construed so as to impose a tax on sales in excess of reasonable requirements, unconstitutional in that (a) the act unconstitutionally delegates legislative and taxing power to the Commissioner; (b) the regulation is not authorized by, and is not within the framework of, any taxing statute, and is therefore an invalid and unauthorized basis for the exaction of any tax?

3. Where, in 77B proceedings, a debtor is continued in possession, and a tax claim based on sale of tax exempt alcohol in excess of customers' reasonable requirements is disputed by the debtor and referred to a master who, on the claimant's testimony and debtor's demurrer thereto, disallows the claim, may a reviewing court reverse the master and allow the claim without remanding the cause to the master with instructions to hear testimony in opposition thereto, particularly where trustees for the debtor representing large and substantial creditor interests, were appointed after the master's hearings had been concluded and his report filed?

4. May a reviewing court set aside findings of fact of a special master appointed in 77B proceedings where the master, but not the court, has seen and heard the witnesses and the master's findings of fact are sufficiently and adequately supported by the testimony?

5. Did the Circuit Court err in imputing the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin where, with respect to such wrongful acts and knowledge, the salesmen were engaged, beyond the scope of their authority, and adversely to the interest of Mifflin, in an independent, fraudulent enterprise, whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed?

6. Did the District Court err in making its own specific findings of the amount of sales of alcohol in excess of Mifflin's customers' reasonable requirements, in view of the fact that the Master, Judge Bard, and the Collector all stated that the testimony lacked competent evidence of the amount of sales in excess of reasonable requirements?

Reasons for Allowance of Writ.

The grounds relied upon by petitioners for the allowance of the writ are:

1. The Circuit Court has decided an important question of federal law which has not been, but should be, settled by this Court, to wit, whether sales in excess of reasonable requirements of customers are taxable under Section 4 of the Liquor Law Repeal and Enforcement Act of 1935 (Act of August 27, 1935, c. 740, § 4, 49 Stat. 873, 27 U. S. C. 153), since repealed and incorporated as Section 3111 of the Internal Revenue Code of 1939 (Act of February 10, 1939, c. 2, § 3111, 53 Stat. 1, 26 U. S. C. 3111), and Article 146 of

Regulations No. 3, relative to industrial alcohol, as amended by Treasury Decision 4541, approved April 17, 1935 (Volume 33, Treasury Decisions, Internal Revenue, 90, 93).

2. The Circuit Court has decided an important question of federal law which has not been, but should be, settled by this Court, to wit, the constitutionality of the said Act and Regulation when construed so as to impose a tax on sales of rubbing alcohol compound by a permittee in excess of its customers' reasonable requirements.

3. The decision of the Circuit Court is in conflict with decisions of other circuit courts in that it failed to hold that, since the case arose on a demurrer to the claimant's testimony sustained by the Master, it was error for the District Court to allow the claim without remanding the cause to the Master with instructions to hear the testimony of the Trustees in opposition to the claim, particularly since the Trustees were appointed only after the Master's hearings had been concluded and his report filed with the District Court.

The conflicting cases of other circuit courts are as follows:

In re John H. Livingston Co., 144 F. 971 (C. C. A. 2d, 1905);
In re Crandall, 205 F. 689, 692 (C. C. A. 9th, 1913).

4. The decision of the Circuit Court is in conflict with decisions of this Court and other circuit courts in that it failed to hold that the District Court erred in setting aside the findings of fact of a master appointed in 77B proceedings where the master, but not the court, has seen and heard the witnesses, and the master's findings are sufficiently and adequately supported by the testimony.

The conflicting decisions of this Court and other circuit courts are as follows:

Kimberly v. *Arms*, 129 U. S. 512, 9 S. Ct. 355 (1888);
Matter of Rubins, 74 F. (2d) 432 (C. C. A. 7th, 1935), cert. den. 295 U. S. 758, 55 S. Ct. 915 (1935);
Clements v. *Coplin*, 72 F. (2d) 796 (C. C. A. 9th, 1934).

5. The decision of the Circuit Court is in conflict with decisions of this Court and other circuit courts in that it imputed the alleged wrongful acts and knowledge of Mifflin's salesmen to Mifflin; since, with respect to such wrongful acts and knowledge, the salesmen were engaged beyond the scope of their authority, and adversely to the interest of Mifflin in an independent fraudulent enterprise whose success would be defeated by disclosure to Mifflin of the acts or knowledge sought to be imputed.

The conflicting decisions of this Court and other circuit courts are as follows:

Schutz v. *Jordan*, 141 U. S. 213, 11 S. Ct. 906 (1891);
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Dixie Guano Co. v. *Wessel*, 296 F. 433 (C. C. A. 4th, 1924);
Great American Indemnity Co. v. *First National Bank*, 100 F. (2d) 763 (C. C. A. 10th, 1938).

6. The decision of the Circuit Court is in conflict with decisions of other circuit courts in that it permitted the District Court to make findings of specific quantities in the absence of competent evidence with respect to quantities.

The conflicting decisions of other circuit courts are as follows:

Forbush v. *Bartley*, 78 F. (2d) 805 (C. C. A. 10th, 1935);
Matter of Sheinman, 14 F. (2d) 323 (D. C. E. D. Pa., 1926);
Matter of Robin, 32 Am. B. R. (N. S.) 462 (D. C. Tex., 1937).

Prayer.

WHEREFORE, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the Circuit Court of Appeals for the Third Circuit, commanding that court to certify to and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket October Term, 1940, No. 7692, In re Mifflin Chemical Corporation, Debtor (Reorganization Proceedings—Section 77B), John E. Sheridan and Leo A. Crossen, Trustees, Mifflin Chemical Corporation, Debtor, Appellants, *v.* Walter J. Rothensies, Collector of Internal Revenue, Appellee; and that the decree of the Circuit Court for the Third Circuit may be reversed by this Honorable Court, and that your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

And your petitioners will ever pray.

WEXLER & WEISMAN,
HARRY SHAPIRO,
Counsel for Petitioners.